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¶1. (SBU) Summary. Hong-Kong-based HSBC bank last week announced it had issued the first Renminbi-denominated letter of credit in which none of the trading parties involved came from mainland China. The move was the latest step towards Beijing's stated goal of establishing the Renminbi (RMB) as an internationally-accepted currency for financial and trade settlements and, eventually, achieving global reserve status. Over the last three years, China has implemented a series of programs to increase international use of the RMB, although as yet these initiatives are still extremely limited and under-utilized. The tentative nature of China's moves has inspired some commentators to question Beijing's commitment to undertake the systemic foreign exchange and financial system reforms necessary to make the RMB an attractive or practical international currency. Although many senior Chinese officials believe the Renminbi eventually should become a key international currency, commensurate with the country's status as the world's (soon-to-be) second largest economy and largest goods exporter, this conviction is far from universal. Virtually all observers expect the PRC Government to move gradually and carefully toward internationalization of the RMB, but most expect the process to take many years. End Summary.

First (Baby) Steps

¶2. (U) On February 3, HSBC Malaysia issued the first RMB-denominated letter of credit involving both a bank, importers, and exporters all outside of mainland China. Last week's groundbreaking transaction followed HSBC's similarly novel transactions in 2009, when it became the first foreign bank to execute a RMB trade settlement in Malaysia. Subsequently, the firm conducted similar arrangements in Hong Kong, Brunei, Indonesia, Singapore, Thailand, the Philippines and Vietnam, all in partnership with the Mainland's Bank of Communications (BoCom).

¶3. (SBU) HSBC's moves were possible because of the

Chinese government's announced policy to increase the use of the RMB in international transactions, with the stated goal of making the RMB an international reserve currency. In this vein, over the last several years Beijing has approved several reforms and pilot programs aimed at increasing the number of RMB-denominated financial tools and providing RMB to a few actors to use in international settlements. For example, in 2007 Beijing began allowing a few select Mainland (and later Hong Kong) banks to issue RMB-denominated "panda" bonds in order to both allow institutions to raise money in RMB and to provide some tradable RMB financial tools. In late-2008 and early-2009, Beijing signed currency swap agreements worth USD 124 billion with Malaysia, South Korea, Belarus, Indonesia, Argentina, and Hong Kong. In theory these swaps could allow central banks to hold RMB, and could push RMB out of China should traders wish to settle their transactions in PRC currency.

¶4. (SBU) Under a pilot program begun in July 2009, a select group of 400 Chinese companies were allowed to price their exports in RMB. Transactions were permitted to take place through accounts established in Hong Kong and five selected mainland cities (Shanghai, Shenzhen, Guangzhou, Zhuhai and Dongguan). Another pilot project covers trade between the ten Association of Southeast Nations (ASEAN) member countries and Yunnan and Guangxi Provinces. These trade settlement programs were intended to increase the presence of RMB in the Hong Kong banking system by up to USD 70 billion in the first year, and also to create demand for more RMB-denominated financial products. Providing more of those financial products, the first Chinese government bond sale outside the mainland occurred in Hong Kong in

September 2009, when China's Ministry of Finance officially launched the sale of RMB 6 billion (USD 879 million) worth of sovereign bonds.

Limited Progress

¶5. (SBU) China's initial efforts at RMB internationalization have not been an unmitigated success. The Chinese currency is still rarely used in global foreign exchange markets and almost no global foreign exchange reserves are held in RMB, primarily because the currency is only partially convertible. Thus far there has been less usage of the RMB-denominated trade settlement agreements and interest in the bond issues than was expected (REF C).

¶6. (SBU) A Chinese economist explained to Econoffs that the amounts involved in the trade settlement agreements and bond issues were "miniscule" compared to overall trade numbers and the size of the Hong Kong capital market. A Hong Kong-based HSBC analyst agreed that the "take-up has been very low" and that there was a "high degree of stage management" at the launch of a trade settlement pilot project in Hong Kong earlier this year. He claimed that some of the corporations listed in the scheme were not in fact participating, and other corporate executives admitted that they were participating purely for political reasons and had no business interest in the project. Banking contacts have explained that foreign traders are reluctant to denominate in RMB since they cannot hedge their currency risk (due to the lack of a liquid, transparent market for Chinese RMB forwards or exchange rate swaps) and the system is still not user-friendly (REF D).

¶7. (SBU) Regarding the bilateral swap agreement, hailed by Beijing as a step toward ensuring greater use of the RMB in international commerce, Embassy contacts generally dismissed the swaps as "mostly window dressing." A Chinese banker said the swaps were set up to show Asian countries that the RMB could be a regional currency. But a local Chinese economist working for a foreign bank told Econoffs that the swaps did little to advance RMB internationalization, adding that they were designed to operate more like an emergency credit line and "in fact were not used extensively."

Questioning Beijing's Intentions

¶8. (SBU) Beijing's slow pace in implementing the reforms necessary for RMB internationalization has led to criticisms that the government is not serious about the goal of establishing the RMB as an international reserve currency. The HSBC analyst explained that Beijing is "playing a cute game," positing that if China had really wanted to internationalize the currency it could have done so by now. Importantly, he opined that Beijing would like to become more "globally relevant without taking on any risks." Put another way, one Bank of China economist said the difficulty centered on the fact that China wanted to promote full convertibility, but also wanted stability, so full internationalization was "not yet possible." The local Chinese economist working for a foreign bank was less critical, noting that "they have to start somewhere." She argued that while, at the moment, the rules on trade settlement and bond issuance were very strict, Beijing was working to loosen them, which would increase participation.

¶9. (SBU) In part, the Chinese go-slow approach to RMB internationalization reflects Beijing's preference to proceed cautiously when it comes to any major financial reforms. However, it also represents an on-going debate among policymakers on the wisdom of moving forward quickly towards full use of the RMB in international transactions.

RMB-Boosters

¶10. (SBU) Some of those pressing most strongly for a greater role for the RMB are concerned about hedging dollar risk. Former PBOC Vice Governor Wu Xiaoling said at the annual Caijing magazine conference on December 18, 2009 that the RMB should play a role in building a multi-reserve currency system to cushion U.S. dollar fluctuation risk. The recent rapid growth of the U.S. fiscal deficit has -- regardless of the reality -- reduced Beijing's confidence in the stability of the dollar and the value of dollar-denominated assets, which are estimated to constitute about two-thirds of China's USD 2.4 trillion of foreign exchange reserves. The Chinese economist told Econoff that "one of the main motives behind the [RMB internationalization] initiative is the weakening dollar, which is under threat from structural problems in the United States." She explained that by conducting trade using RMB, China would hope to reduce dollar and foreign exchange accumulation. RMB-denominated trading, the argument continues, also would somewhat insulate Chinese exporters from foreign currency volatility. (Comment: These arguments are somewhat specious from an economic standpoint. In many cases the popular

arguments for RMB internationalization belie a limited understanding of the economics underpinning the process. China will continue to acquire foreign reserves as long as it runs a large surplus, and exporters will still always assume foreign currency risk in terms of fluctuating prices if not fluctuating exchange rates. Comment.)

¶11. (SBU) Beyond these relatively direct, if not entirely practical, considerations, other supporters of RMB internationalization are clearly looking for "soft power" gains in political, economic, and financial global fora. This view is widespread in China: as Chairman Li Jiange of China International Capital Corporation (CICC), a major Chinese investment bank, recently asserted in a public speech: "I believe it is a historical responsibility for China to have a bigger voice globally." Former Hong Kong Monetary Authority CE Joseph Yam and current PBOC advisor has called for the RMB to become a "third pillar" of the global monetary system. Speaking privately, senior Chinese officials have noted that the RMB could become a component of the IMF's Special Drawing Rights Basket, but for symbolic, political reasons rather than a practical reflection of the RMB's internationalization (REF A). The position that the Chinese currency eventually should become a key international currency, commensurate with China's rapidly expanding political and economic clout is widely popular, and frequently supported by popular commentators and netizens.

¶12. (SBU) Still another group advocating RMB internationalization hopes to leverage this popular support for RMB internationalization into larger (and less-popular) financial and foreign exchange reforms. The managing director of a major Chinese investment bank said that RMB internationalization would serve China, because reformers could use it to further economic reform. He claimed every decade needs a popular objective to drive reform: in the 70s, it was land reform; in the 80s, opening to foreign investment; in the 90s, preparation for WTO accession; now, RMB could play this role. Likewise, a well-known Chinese pundit at the Chinese Academy of Social Sciences (CASS) has actively promoted RMB internationalization, because in order to achieve such global status China must fundamentally reform its foreign exchange and financial systems.

Verses the Go-Slow Club

¶13. (SBU) In fact, one of the major reasons for the slow pace of RMB internationalization is the need for -- and opposition to -- such systemic reforms (see REF E for a full explanation of the required changes). Beijing has made no secret of its desire

to proceed deliberately. Premier Wen Jiabao said at the September 2009 World Economic Forum in Dalian, China that China had made "progress in the RMB's internationalization, yet it would take quite some time before the RMB truly became an international currency." Likewise, Li Yang of Chinese Academy of Social Sciences (CASS) told Econoffs that the RMB internationalization process would be very long, with the government's steps of the past year (e.g. use of RMB for cross-border settlement, currency swaps) just the start.

¶14. (SBU) The requirement for a more flexible exchange rate system, and thus significant exchange rate appreciation, faces significant opposition.

The RMB effectively has been pegged to the U.S. dollar for the past year and a half; resumption of the appreciation, either through a one-off adjustment or use of a more flexible exchange rate mechanism, would be opposed by various power bases in China, including most of the economic ministries, provincial and local governments, and export industries fearful of losing price competitiveness due to currency appreciation (REF B).

¶15. (SBU) Further, for the RMB to become truly international China also would need to open and develop its capital markets. Not only would this imply a significant loss of government control over the economy, but without a flexible exchange rate regime it could generate capital flows that would likely disrupt domestic financial conditions and hinder the PBOC's ability to conduct monetary policy. In recent times, China has been able to intervene and address this problem through sterilization, at a large and rising cost. In the future, when those costs would eventually become prohibitive the central bank would be forced to choose between currency appreciation and domestic inflation. Underlying all of this is the fact that foreign investors would not want RMB unless there were financial products in which they could invest, and traders settling transactions in RMB would want to be able to hedge their foreign exchange risk.

So What is the Plan?

¶16. (SBU) Looking forward, the Chinese economist asserted that "it is not clear that there is a coherent strategy or even a coherent idea of what is meant by internationalization." The CASS professor agreed that, at the moment "there is no plan" for RMB internationalization. There may be, however, an informal "academic and governmental consensus" on several possible alternatives for the future which the government is pursuing simultaneously. A foreign academic noted that even if China was not sure yet what it wanted, "by simply bringing up various ideas, China was setting up the global agenda and debate."

¶17. (SBU) Without a plan, virtually all observers expect the Chinese Government to move gradually and carefully toward internationalization of the RMB. A convertible RMB and flexible exchange rate would come first, but not for perhaps 5-10 years. Open capital markets would also take at least 10 years. But some are even more conservative: when asked to provide a time line for RMB internationalization, the professor answered: "maybe in my lifetime" (he is 61). In all likelihood, the sophisticated financial market, improved infrastructure, adequate supervision and transparency required for RMB reserve status is decades in the future.

HUNTSMAN